
Cashless in Kolkata

Mushtaq Khan & Danish Hyder, December 2, 2016

Why would India take this step?

Glancing through the media coverage of India's November 8th decision to demonetize the ₹ 500 and 1,000 notes, one would have to concede this was an unprovoked policy blunder. Having been hailed as the fastest growing economy in the world (which is now facing global uncertainty created by Brexit and President-elect Donald Trump), why would India impose this ordeal on the average Indian, now?

CNN regularly covers the long lines outside banks and ATM machines; the despair of low and middle-class Indians who are unable to buy medicine; the alleged death toll linked to this issue; and waivers granted to toll-booth operators and farmers to ensure that India's economy does not come to a grinding halt. The shock announcement and apparent lack of preparation, suggests that India's policymakers may have momentarily lost their collective minds.

The government almost seems intent on testing Indians to their limits: be it by limiting how much cash an individual can change in a day; or how much an account holder can withdraw on a daily or weekly basis; or the embarrassing large number of non-operational ATMs.

Media outlets and commentators unanimously claim that India's demonetization decision was unwise. Furthermore, the political storm this triggered suggests that this policy decision could prove to be Modi's last.

Intent versus Implementation

Media coverage makes two things very clear: demonetizing has been poorly implemented, but the intent to target the fat-cats (with ill-gotten gains) is widely applauded. There is a sense that even though this decision has angered many Indians, the fact that it has black marketeers panicking (and possibly losing hundreds of millions of Dollars), is almost pleasing to the cable-watching nation.

It is increasingly clear that the vast majority of Indians are not that interested in going cashless; rather they are energized by the prospect that the government has promised to catch and penalize fat-cats. Since this appears to be the real motivation for their support, the manner in which Modi's government handles people who declare their black money, will determine how this political gamble plays out.

Who holds cash?

The short answer is everybody.

But for a central banker, if the cash holdings of an average Indian are far in excess of what he/she needs to buy weekly groceries, or pay utility bills, or for the one-off meal at a local restaurant, there is a problem.

There are striking similarities between Pakistan and India – especially in terms of the attitude towards documenting commercial activity, paying taxes and hoarding cash. According to the State Bank of Pakistan, as of end-December 2015, Pakistan's cash holding as a percentage of total money supply was 21% compared to India's 8%; Bangladesh stands at 10%, and Sweden is at an almost cashless 2.6%. Yet, India moved first.

In our view, what is happening in India, may be instructive for Pakistan.

Some people intentionally hold cash balances, while many simply hold cash because they see no viable alternative. Let's first focus on the latter: (1) the widow who has never had a bank account – this carries across generations as learned behavior; (2) small farmers who really don't know any better; (3) shopkeepers who sell primarily for cash; (4) large wholesalers (cotton; wheat; agri produce; gold-traders; rural middle-men; etc.); and (5) the poor and lower-middle class who keep cash balances in case of emergencies.

Then there are those who must deal in cash because their underlying business is either illegal, or the source of money is bribery or corruption. More specifically, we would list the following: (1) petty officials in provincial and local governments (and public sector enterprises), who view bribes as innocuous “speed money”; (2) more senior government officials, who may expect suitcases; (3) smugglers who only transact in local currency or Dollars; (4) moneychangers – Hundi in Pakistan, Hawala in India; (5) real estate developers; (6) criminal gangs; and (7) Bollywood.

What is the goal of demonetization?

Such a disruptive policy must have significant upsides (and strong political will behind it) to even be considered, let alone implemented. In India and Pakistan's case, we would rank the potential positives as follows: (1) comprehensively documents all financial transactions; (2) discourages corruption; (3) encourages more people to enter the financial system; (4) forces large wholesalers to give up parallel forms of (fiat) money; and (5) reduces the demand for currency notes.

The primary goal of demonetization is to document all financial transactions that sustain economic relationships. Creating this social and economic dependency, is a hallmark of civilization. Comprehensive documentation will help banks become more efficient financial intermediaries. Furthermore, this will help small & medium size enterprises (SMEs) and farmers, who are largely excluded from the banking system. Documentation will create a history of commercial transactions, which will allow banks to target this forgotten segment of the country's population.

Documentation will also help the tax authority move away from regressive (indirect) taxes. This includes sales tax, VAT and other duties, which are priced into most goods and services. Irrespective of how rich a person is, he/she pays the same amount as someone who is living hand-to-mouth.

Documentation will also identify those who should be paying income tax, which will make the tax burden fairer.

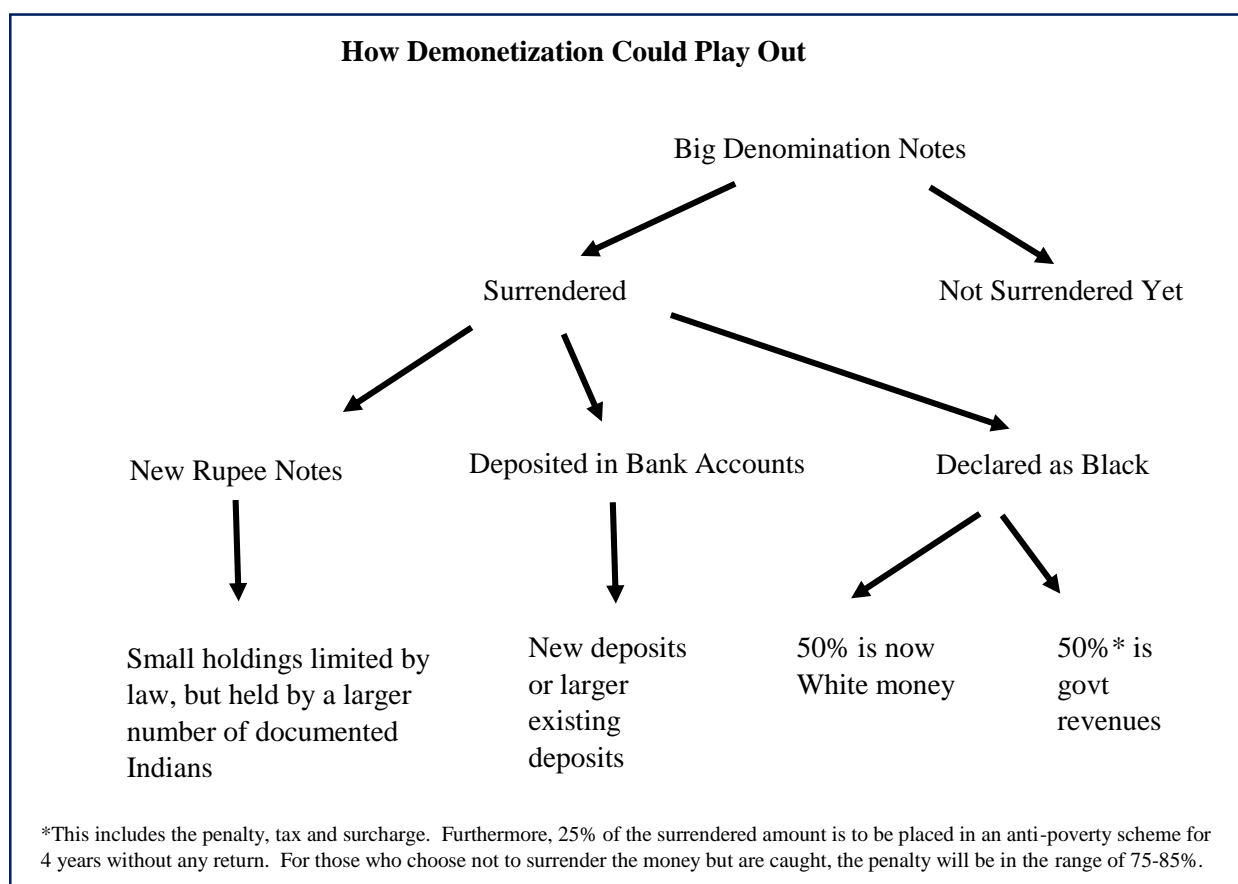
A final point: if hoarding cash is deemed to be risky and documentation is more comprehensive, the giving and accepting of bribes will definitely fall.

How has India fared?

The Reserve Bank of India (RBI) has stated that as of November 28th, of the ₹ 14 trillion that has been demonetized, 57% has been deposited in bank accounts and 3% has been exchanged for new currency notes. 40% remains in the form of old notes, and is likely to surface as the end-December deadline looms. It is impressive that the bulk of this converted money has been placed in the banking system (rather than being withdrawn in cash), which should increase bank lending to Indian businesses.

The flowchart depicts how the demonetization is playing out. The currency already exchanged by the average Indian, is predominantly going into bank deposits, which nudges the economy towards a more cashless environment.

At this stage, one should make a distinction between the 2 goals of a demonetization exercise: one, to reduce currency in circulation and increase documentation by shifting currency notes into the banking system; and two, to penalize the fat-cats who hold a large share of this currency.



In our view, the people who have come forward so far are the unintentional holders (i.e. the average Indian). This could include the widow whose life savings of ₹ 22,000, are converted back into cash (new notes) by repeatedly going to the same bank, because she is constrained by how much money she can exchange on a weekly basis. She is uninterested in having a bank account, and complains bitterly about the inconvenience she has to bear.

Then there are the fat-cats. One could be holding as much as ₹ 200 million in old notes, and panic has already set in. The fat-cat first tries to convert his notes into gold and then Dollars, but as the premium increases on both these assets, he is forced to seek alternatives. He then gathers a group of trusted people, and gives them small chunks to deposit (as their money) in existing or new bank accounts. As the end-December deadline approaches, and he is still left with uncomfortably large cash balances, he has little choice but to approach the authorities and concede that he possesses 'black money', and is willing to pay the penalty to whiten his ill-gotten gains.

This implies that India's black money will be surrendered largely in the second half of December.

End-game

So how and when will Modi's government declare victory? Clearly this has to wait till the fat-cats have run out of options as the deadline expires. This successful closure could entail the following messages:

(1) boasting that the bulk of old currency notes have been converted into bank deposits, which will help the private sector; (2) highlighting how much revenue has been generated from the fat-cats alone; and (3) announcing that this revenue (from the penalty payments) will be earmarked for public spending on infrastructure and social services in the province/district where the money was collected. This point will seek to strengthen the *Social Contract* between the government and the people (more later).

So, the key question is not why Modi's government took this decision, but rather why it took this decision now.

Geopolitical dimension

The global economy is still reeling from Brexit and the incoming Trump administration. It also appears the unipolar world order is changing into a multilateral system. As power shifts to Asia, China and India are jostling to shape the future.

Under Premier Xi Jinping, China has embarked on a significant exercise to root out corruption. Since the Chinese economy is better documented than India's, this suggests that a proper exercise to tackle corruption cannot be effective without comprehensive documentation. Hence, demonetization should be viewed as an important first step in tackling corruption, and thereby strengthening the foundations of the Indian economy.

Perhaps current global developments have compelled India's government to clampdown. India needs to upgrade its physical infrastructure and clean up its government machinery, if it wants to punch at its global weight. It would also want to ensure there are no known unknowns that can interfere with decision-making. If India wants a seat at the big table, it needs to show it can take charge of its domestic economy.

Although corruption exists in OECD countries, the petty corruption that characterizes both Pakistan and India is embarrassing.

Conclusion

In countries where the writ of law is not binding on the rich and influential, there is a tendency to flagrantly defy the obligation to document financial transactions and pay taxes. This does not go unnoticed by the less affluent, who are not so much envious of the lifestyles of the rich, as they are resentful towards them. As the Brexit decision and the US elections have shown, when expressed through a voting process, this anger will favor those who make a strong distinction between 'haves' and 'have-nots'.

The decision to demonetize the ₹ could be the first step in rewriting the Social Contract in India. If the vast majority of people feel their representatives are not delivering, basic rules of social order fall apart, especially if regulation and local law enforcement are viewed as corrupt and self-serving. To reinforce this 'Contract' with the people, the government must take steps that will hurt the fat-cats.

Targeting people who have vast holdings of unaccounted-for cash, is a good starting point. While cash may not be the primary stock (reservoir) of ill-gotten wealth, it is the main conduit whereby this wealth is generated and transacted. This means that intentionally hidden financial transactions must be done using suitcases of cash, as the use of banking channels (which are documented) could be questioned by the tax authorities. In effect, undermining confidence in cash may be a way to discourage the generation and use of black money.

Having said this, the end goal of documentation is not to punish black marketeers per se, but to ensure that everyone contributes to the upkeep of the country. In a sense, it appears the Indian government has taken the first tough step, which has been hard on the people. In return, Indians expect their government to deliver a less corrupt government machinery, which allows for a tangible improvement in social services.

Only then will it be possible to talk about a new Social Contract, where citizens feel that paying taxes in return for social services, is a good deal.

Demonetization is a political gamble, but one a country like India had to take. As Asia rises in the global order, Pakistanis should also consider a similar path towards documentation and financial deepening. As discussed in Pakistan's print media, we agree that focusing on the Rs 5,000 note alone, would be far more targeted and much less disruptive than India's experience.